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UNCLAS KINGSTON 000830

SIPDIS

STATE FOR WHA/CAR/ (WBENT), WHA/EPSC (JSLATTERY)

SANTO DOMINGO FOR FCS AND FAS

TREASURY FOR L LAMONICA

E.O. 12958: NA

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SUBJECT: JAMAICA'S INTEREST RATES DROP TO RECORD LOW

1. The Bank of Jamaica (BOJ), on March 7, reduced the rates on open market instruments for the second time this year. This is a continuation of the trend started in 2004, when interest rates were slashed eleven times. Interest rates have now moved from a high of 36 percent on 365-day instruments at the end of March 2003 to 14.95 percent in March 2005. The overall rate cuts, which range from 0.5 percentage points to 0.55 percentage points have brought interest rates to their lowest levels since February 2003. Declining interest rates are an important ingredient in the GOJ's medium term program as, in addition to reducing debt-servicing costs, it sets the stage for increased private sector borrowing and, by extension, economic expansion. Reduced interest rates should also boost consumer credit, thereby stimulating demand for goods and services.

2. According to the Bank of Jamaica (BOJ), the interest rate adjustments were underpinned by steady improvement in Jamaica's macroeconomic indicators. In particular, the exchange rate has remained stable since the beginning of the year reflecting buoyant foreign exchange inflows from tourism and remittances. Tourism receipts amounted to USD 1.4 billion in 2004, up 6.4 percent, while remittances of USD 1.5 billion increased by 15.5 percent over 2003. These combined with strong bauxite/alumina earnings led to a USD 8.5 million improvement in the country's current account balance. These inflows have led to a build-up in the stock of net international reserves, which remain around USD 1.8 billion, a level the BOJ argues is adequate to underwrite near term stability. Prices are also expected to moderate in the upcoming fiscal year, which begins in April. Going forward, the Bank expects the macroeconomic fundamentals to continue, if not improve. The central bank also said it remained firmly committed to preserving orderly conditions in the money and foreign exchange markets.

3. Financial analysts have traditionally argued that investors would switch to US Dollars once Jamaican interest rates reached 16 percent. However, despite the reduction in risk premium accompanying the lower interest rates, investors have not rushed to the foreign exchange market. This suggests increasing levels of confidence in the Jamaican economy. In addition, the stock market has not reacted to the reductions in interest rates, indicating that investors had already factored the lower interest rates into their investment decisions. The improvement in the economic fundamentals and interest rate reductions in particular could very well strengthen veteran Minister of Finance and Planning Omar Davies' increase his chances of making a serious bid for the presidency of the People's National and, ultimately, Prime Minister.

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